No. 15,273

IN THE

United States Court of Appeals
For the Ninth Circuit

PACIFIC VEGETABLE OIL CORPORATION, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	

BRIEF OF PETITIONER.

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BRIEF OF PETITIONER.

I.

JURISDICTION.

Petitioner is a corporation organized and existing under the laws of the State of California, with its principal place of business in the City and County of San Francisco, State of California.

Petitioner filed its Federal Income Tax Return for its taxable year ended December 31, 1949, with the Collector of Internal Revenue for the First District of California, whose office is located within the jurisdiction of the United States Court of Appeals for the Ninth Circuit.

On June 5, 1953, a notice of deficiency was mailed to petitioner by the Commissioner of Internal Revenue

(T.R. 11-18). On August 31, 1953, petitioner filed in the Tax Court of the United States its petition for a redetermination of the deficiency in income tax liability as set forth in said notice of deficiency (T.R. 4). Jurisdiction of the Tax Court was based on Section 272(a) of the Internal Revenue Code of 1939.

On August 5, 1956, the Tax Court of the United States entered a decision determining a deficiency in income tax for the calendar year ended December 31, 1949 (T.R. 118-119).

Jurisdiction of this Court to review the aforesaid decision of the Tax Court of the United States is founded on Sections 7482 and 7483 of the Internal Revenue Code of 1954.

On August 17, 1956, petitioner filed in this Court its petition for review (T.R. 119).

II.

STATEMENT OF THE CASE.

The Tax Court decision dealt with two separate and distinct issues, designated in the Tax Court opinion as Issue 1 and Issue 2. Only the second of these issues is presented for consideration in this Petition for Review, Issue 1, as shown in the "Statement of Points to Be Relied on Upon Review" (T.R. 123), having been eliminated subsequent to the filing of this petition.

The issue before this Court involves the application of Section 115(g)(1) of the Internal Revenue Code

of 1939 to certain corporate distributions made in the calendar year 1949 by Western Vegetable Oils Company, Incorporated, a corporation, to Petitioner, one of Western's shareholders and likewise a corporation.

Section 115(g)(1) reads as follows:

> "If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such times and in such manner as to make the distribution and cancellation in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

Petitioner is a corporation organized and existing under the laws of the State of California, with its principal place of business in San Francisco, California. Western, the distributing corporation, is a corporation likewise organized and existing under the laws of the State of California, with its principal place of business in San Francisco, California. It was organized in the year 1935 for the purpose of engaging in the vegetable oil business, chiefly in the crushing of copra and other oil-bearing materials for the production of coconut oil and meal and other vegetable oils and meals therefrom. It continued to engage in this business until March 31, 1954, at which time its copra crushing operations were discontinued as a result of unfavorable economic conditions in the

copra crushing industry (Stipulation of Facts, Para. IV, T.R. 21).

At the beginning of the year 1949, Western had 5,182 shares of common stock outstanding; 2,094 or 40.4091 per cent, of these shares being held by Petitioner, 1,252 shares, or 24.1605 per cent being held by A. A. Schumann, and the remainder by eight (8) other shareholders, one of the latter, the estate of a deceased shareholder (Stipulation of Facts, Para. V, T.R. 21 and 22).

Between April 30, 1949, and January 10, 1950, Western acquired all of its shares owned by shareholders other than Petitioner and A. A. Schumann. From Petitioner, it acquired 1,346 of the 2,094 shares owned by Petitioner and from Mr. Schumann, none. All of the shares so acquired from all shareholders, with the exception of 140 shares acquired from the estate of a deceased shareholder on April 30, 1949, were acquired for the same cash distribution, namely, $220.00 a share. All shares so acquired were surrendered to Western and cancelled (Stipulation of Facts, Para. VI, T.R. 22 and 23).

When these acquisitions were concluded, there remained outstanding 2,000 shares of Petitioner's stock, 1,252 in the hands of Mr. Schumann and 748 in the hands of Petitioner. On February 17, 1950, Petitioner purchased from Schumann 252 shares of stock held by him in Western at a price of $220.00 per share, for the purpose of rendering the ownership of Petitioner and Schumann of all of the outstanding stock

of said corporation equal (Stipulation of Facts, Para. VI, T.R. 23). Petitioner and Schumann then each owned 1,000 shares and were the sole shareholders of Western.

At the beginning of the year 1949, Western had earned surplus available for the payment of dividends in the amount of $768,299.64. All sums distributed to shareholders in the course of acquiring their stock were charged to earned surplus, leaving $503,756.80 in earned surplus at the end of 1949, after the 1949 distributions (Stipulation of Facts, Exhibit 9-I, T.R. 42).

After these distributions and the acquisition of shares above mentioned, Western's operations continued until March 31, 1954, in the same manner as in prior years, processing approximately the same quantities of copra and other oil-bearing materials, maintaining the same volume of gross sales, and maintaining and operating all plant and equipment owned by it prior to the stock acquisition (Stipulation of Facts, Para. VII, T.R. 24, 25 and Exhibit 10-J, T.R. 43).

In its Income Tax Return for the year 1949, Petitioner reported the $296,120 it had received from Western in consideration of surrender of 1,346 of its 2,094 shares of stock as a dividend, on the basis that the distribution was "essentially equivalent to the distribution of taxable dividend" within the meaning of Section 115(g)(1), Petitioner having disposed of only a portion of its stock, Western having had ample earned surplus available for the declaration of divi-

dends, having charged the distribution to earned surplus, the control of Western not having substantially changed as between Petitioner and Schumann, Western having continued in business after the distribution in substantially the same manner as before, and there being no legitimate business purpose to justify the distribution by Western.

The Commissioner of Internal Revenue insisted upon treating the distribution as a distribution in partial liquidation, and, therefore, Petitioner's receipts as capital gain. The Tax Court supported the Commissioner's contention, and the issue in this case is whether the Tax Court was correct in doing so.

III.

STATUTES AND REGULATIONS INVOLVED.

The pertinent parts of the statutes and regulations involved in this case are as follows:

Internal Revenue Code of 1939, sec. 115:

Distributions by corporations.

"(c) Distributions in Liquidation. . . . amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock . . . In the case of amounts distributed . . . in partial liquidation . . . the part of such distribution which is properly chargeable to capital accounts shall not be considered a distribution of earnings or profits . . .

(g) Redemption of Stock.

1. In General. If a corporation cancels or redeems its stock . . . at such time and in such

manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(i) Definition of Partial Liquidation. As used in this section the term 'amounts distributed in partial liquidation' means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation of redemption of all or a portion of its stock.

Regulations 111:

Sec. 29.115-5. Distributions in Liquidation. Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock so cancelled or redeemed. . . .

The term 'amounts distributed in partial liquidation' means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions or redemptions of all or a portion of its stock. A complete cancellation or redemption of a part of its stock may be accomplished, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by a complete retirement of any part of the stock, whether or not pro rata among the shareholders.

Sec. 29.115-9. Distribution in Redemption or Cancellation of Stock Taxable as a Dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation of redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend."

IV.

SPECIFICATION OF ERRORS.

1. The Tax Court erred in holding and deciding that a distribution in cash in the amount of $296,120 received by Petitioner from Western Vegetable Oils Company, Inc., in the year 1949 constituted a distribution in partial liquidation within the meaning of Section 115(i) and taxable under the provisions of Section 115(c), Internal Revenue Code of 1939.

2. The Tax Court erred in failing to hold and to decide that this distribution to Petitioner by Western Vegetable Oils Company, Inc., constituted a distribu-

tion essentially equivalent to the distribution of a taxable dividend within the meaning of Section 115(g) of the Internal Revenue Code of 1939, in view of the fact that

(a) said distribution was made in cash and was charged to Western's earned surplus account;

(b) Western had sufficient earnings and profits accumulated since February 28, 1913, to cover said distribution and all other like distributions;

(c) Western maintained all of its plant equipment and other operating assets, and its business continued after the distribution in substantially the same manner and at substantially the same volume as before the distribution; and

(d) Petitioner's interest in and degree of control of the distributing corporation was substantially the same after as before the distribution.

(e) There was no legitimate business purpose to justify the distribution by Western.

3. The Tax Court erred in holding and deciding that Petitioner realized capital gain from said distribution.

4. The Tax Court erred in failing to hold and to decide that Petitioner was entitled to a credit against the amount of said distribution, as a credit against net income, in the sum of $251,702 representing 85 per cent of dividends totaling $296,120 received by Petitioner from a domestic corporation, namely, Western Vegetable Oils Company, Inc., under Section 26(b) of the Internal Revenue Code of 1939.

5. The Tax Court erred in holding and deciding that there is any deficiency in income tax paid by Petitioner for the year 1949 resulting from the receipt by Petitioner of this distribution.

6. The Tax Court erred in that its opinion and decision are contrary to law and the regulations, and are not supported by substantial evidence of record.

V.

ARGUMENT.

A.

THE "NET EFFECT" OF A CORPORATE DISTRIBUTION UPON THE DISTRIBUTING CORPORATION IS THE FUNDAMENTAL INQUIRY IN INTERPRETING SECTION 115(g).

It is now firmly established that in applying Section 115 (g) and the regulations thereunder to a corporate distribution, the "net effect" of the distribution on the distributing corporation, rather than the motives and plans of the taxpayer or the corporation, is the fundamental inquiry to be made in deciding whether the distribution is "essentially equivalent to the distribution of a taxable dividend."

The leading case establishing this principle is *Flanagan v. Helvering* (C.C.A. D.C. 1940), 116 F. 2d 937. In this case, the Court said at page 939:

> "But the net effect of the distribution, rather than the motives and plans of the taxpayer or his corporation, is the fundamental question in administering 115(g)."

This principle has been affirmed regularly in a number of cases, examples of which are:

James F. Boyle (1950), 14 T.C. 1382, aff'd. (C.A. 3rd Cir. 1951), 187 F. 2d 557, 40 AFTR 308, cert. denied (1951), 342 U.S. 817;

John L. Sullivan (1952), 17 T.C. 1420, aff'd. (C.A. 5th Cir. 1954), 210 F. 2d 607;

Kessner v. Commissioner, Docket Nos. 53108, 53109, 26 T.C. ...., No. 134 (Sept. 1956), C.C.H. 1956 Reg. Dec. No. 21,924.

B.

THE COURTS HAVE CONSIDERED FOUR FACTORS AS OF MAJOR IMPORTANCE IN DETERMINING "NET EFFECT".

An examination of the cases shows clearly that four factors have been deemed by the Courts to be major factors, of primary importance in determining whether the "net effect" of the distribution is that of a dividend within the scope of Section 115(g), and Petitioner is aware of no cases in which, these factors being present, the Court has failed to hold that the distribution fell within the scope of Section 115(g).

These major factors are:

(1) The distributions have been made entirely from earnings, current or accumulated; and

(2) The distributing corporation has continued in business to substantially the same degree and in substantially the same manner after the distribution as before, manifesting no policy of contraction; and

(3) The control of the corporation and the relationship to the corporation of the shareholder receiving the distribution, as a practical matter, is substantially the same before and after the distribution; and

(4) The distribution and the accompanying redemption of the stock served the purpose of the shareholder receiving the distribution only, and the distributing corporation had no business purpose justifying the making of the distribution and the redemption of its stock.

The foregoing principles are recognized, established, and discussed in the cases heretofore and hereafter cited in this brief.

C.

THE TAX COURT ERRED AS A MATTER OF LAW IN APPLYING THE FOREGOING PRINCIPLES TO THE FACTORS OF THIS CASE.

In the case at bar, the Tax Court gave verbal recognition to the principle that the "net effect" of the distributions is controlling, but failed to apply the principle in the manner in which the principle has been developed in the cases. The Tax Court stated (T.R. 117), "We have considered all of the factors which the evidence discloses." Petitioner contends that an inspection of the Tax Court's opinion shows that the Court, on the contrary, did not consider all of the foregoing factors, did not consider their combined effect, did not give sufficient weight to their ex-

istence, but, by contrast, gave disproportionate weight to relatively unimportant factors in this case, and, finally, in deciding that the distribution was one in partial liquidation, made a determination not founded upon substantial evidence.

I. The Distributions Made by Western, the Distributing Corporation, Were Entirely From Current and Accumulated Earnings.

The Internal Revenue Code of 1939 in Section 115(a) defines a dividend as any distribution made by a corporation to its shareholders out of its earnings or profits accumulated after February 28, 1913, or out of the earnings or profits of the taxable year without regard to the amount of the earnings or profits at the time the distribution was made. Section 115(b) of the same Code provides that "for the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits". Here we have a clear Congressional mandate setting forth that distributions are to be considered from earnings or profits, if available, and are to be considered dividends if from earnings or profits. As the Court said in *Flanagan v. Helvering* (C.C.A. D.C. 1940), 116 F. 2d 937, at page 940:

> "The cases, moreover, for the most part involve instances where the present surplus was not in excess of the distribution, although previously profits had been capitalized. Here, there was an earned surplus of $70,451.49, with current net income of $10,017.20, the distribution

> amounted to $36,800. For a case like this, the statutory declaration of Section 115(b) leaves little, if any doubt. 'For the purposes of this Act (Chapter) every distribution is made out of earnings or profits to the extent thereof, . . .' The distribution, then, came out of earnings and profits. The force of this statutory mandate must be admitted."

This primary factor of the distribution being out of earnings and the Statutory Mandate thereon were virtually ignored by the Tax Court in its opinion. The opinion merely states at page 117 of the Record that "the mere existence of such earnings and profits to cover the acquisition of the stock does not automatically bring the transaction within the provisions of Section 115(g)."

Of course, the "mere existence" of such earnings and profits has no such automatic effect, as in the case of the complete liquidation of a corporation and the cancellation and redemption of all of its shares, the existence of accumulated earnings would not bring the transaction within the purview of Section 115(g). By the same token, the purchase of all of a shareholder's stock so that the shareholder ceases to have the relationship of shareholder to the corporation, does not automatically fall within Section 115(g). See Regulations 111, Section 29.115-9 (supra at page 8) and *Boyle v. Commissioner* (C.A. 3rd Cir. 1951), 187 F. 2d 557. However, the existence of such earnings and profits is an essential element in the application of Section 115(g) since, if such earn-

ings and profits do not exist, the distribution cannot be treated as a taxable dividend by the very terms of the section, and an element so important cannot be dismissed summarily with the mere statement that their "mere existence" has no "automatic" effect. It is submitted that the existence of such earnings does have virtually an "automatic" effect where the other elements considered by the Courts to be important are so plainly present as they are in this case.

In this case there is absolutely no question and no dispute in the evidence that Western not only had very large earned surplus available for the payment of dividends but that the distributions made by Western and in particular the distribution herein issued, were charged directly to earned surplus. The Record shows that Western opened the year 1949 with an earned surplus of $768,299.64, charged all 1949 distributions, which included the distribution to petitioner, to that earned surplus, reducing it thereby to $503,756.80 at the end of the year, after which it was further reduced by the 1950 distribution, but remained substantial after all distributions were completed. (Statement of the Case, supra, page 5).

No part of these distributions was charged to capital account, as, indeed, would have been impossible, as accumulated earnings were not exhausted by the distributions. Under the circumstances, even if a partial liquidation is made, by the provisions of 115(c) if the amount distributed is not "properly chargeable to capital account," it is considered to be a distribution of earnings and profits. The amounts

distributed in the case at bar were distinctly not "chargeable to capital accounts" and thus were clearly distributions of earnings and profits and therefore within the purview of 115(g) and not 115(c).

Despite the vital importance in this type of case of the existence of accumulated earnings and their distribution to the shareholder, the Tax Court completely failed, as its opinion shows, to give appropriate weight to this indispensable element, and we submit that the Tax Court committed error in this respect. *Fostoria Glass Co. v. Yoke* (D.C.W.V. 1942), 45 F. Supp. 962, 964; *Bazley v. Commissioner of Internal Revenue* (C.C.A. 3d 1946), 155 F. 2d 237, 240, 241; *Commissioner of Internal Revenue v. Roberts* (C.A. 4th Cir. 1953), 203 F. 2d 304, 305, 306; *Kessner v. Commissioner of Internal Revenue,* 26 T.C........., No. 134 (Sept. 1956), C.C.H. 1956 Reg. Dec. No. 21,924.

II. Western, the Distributing Corporation, Continued in Business to the Same Extent After the Redemption as Before.

The cases are in accord with the principle that if the distributing corporation continues in business to substantially the same degree and in substantially the same manner after the redemptions, it is further evidence that the distributions were essentially equivalent to a taxable dividend. *Boyle v. Commissioner* (C.A. 3rd Cir. 1951), 187 F. 2d 557, 561; *Smith v. U. S.* (C.C.A. 3rd 1941), 121 F. 2d 692, 695; *Brown v. Commissioner* (C.C.A. 3rd 1935), 79 F. 2d 73, 74; *Commissioner of Internal Revenue v. Roberts* (supra) 306; *Rheinstrom v. Conner* (C.C.A. 6th 1942), 125

F. 2d 790, 796, cert. denied, 317 U.S. 654, 63 S. Ct. 49, 87 L. Ed. 526 (1942).

In the instant case, Western had been formed in 1935 to engage in the principal activity of the crushing of copra and the manufacture of coconut oil and meal therefrom. It continued to engage in these activities until March 31, 1954, when adverse conditions in the copra market and resulting uneconomic operations caused the company to terminate the copra crushing activities. However, both before and after the distribution, Western's activities were maintained at substantially the same level (T.R. 24). In 1948, Western crushed 25,304,012 pounds of copra, in 1949, 38,249,910 pounds, in 1950, 33,875,264 pounds, in 1951, 47,581,862 pounds, in 1952, 38,907,292 pounds, and in 1953, four (4) years after distribution, Western crushed 26,021,450 pounds of copra, more than the crush of 1948. It is evident that there was no contraction in Western's principal business, namely, copra crushing.

Moreover, as the stipulation of facts also shows (T.R. 24), Western continued to maintain in succeeding years all of its plant and equipment and as shown by Exhibit 10-J (T.R. 43), Western's gross sales actually increased materially after 1948. In 1948, its gross sales were $5,617,486.61 from which they increased to $6,551,529.94 in 1951, and in 1953, four (4) years after the distribution, gross sales were $6,164,545.29, substantially higher than in 1948. It is undeniable, therefore, that the business of Western continued unchanged after the distributions and that

no policy of any sort of contraction was manifested by the corporation.

The Courts, in their reasoning on the question of contraction of business, logically hold that if the business continues after the distribution as before, this factor is of major importance in determining that the "net effect" of the distribution in the shareholder is the same as that of a cash dividend (see citations immediately above).

Nowhere in its opinion does the Tax Court make any mention whatsoever of this factor in the instant case. This evidence, strong and unquestioned, is in complete contradiction of the Court's position that the distributions were distributions in partial liquidation. There is, in fact, no evidence in the record to support such a view, and the Tax Court clearly erred in adopting it.

III. Control of the Corporation and Relative Position of Shareholders Remained the Same.

If the control of the distributing corporation or the relative position of the principal shareholders of the distributing corporation as a practical matter remains the same after the redemption as before, the cases are in general accord in holding this factor as evidence tending to prove that distribution was essentially equivalent to a taxable dividend.

Commissioner v. Roberts (C.A. 4th Cir. 1953), 203 F. 2d 304, 306;

Boyle v. Commissioner (C.A. 3rd Cir. 1951), 187 F. 2d 557, 560.

The Congress in enacting the Internal Revenue Code of 1954 recognized this accord and incorporated the test of continuing control as a limitation on capital gains treatment in Section 302(b)(2)(B).

In *Commissioner v. John T. Roberts* (supra), the Court said at page 306:

> "The vital thing here, as we see it, is that by the redemption of this stock the *essential relation* of the taxpayer to the corporation was not, in any practical aspect, changed. Before the redemption he was the sole stockholder in the corporation, after the redemption he was still the sole stockholder. Of what real consequence was it that before the redemption, his sole ownership was divided into 2,000 shares and after the redemption, the same sole ownership was divided into 1,500 shares. He owned the whole corporation before the redemption; after the redemption he was still the sole owner."

In Respondent's own rulings it is so held: "A redemption of stock which does not, as a practical matter, change the essential relationship between the shareholders and the corporation is generally considered equivalent to a dividend." Rev. Rul. 56-521.

The Tax Court was in error in ignoring the "net effect" of the transactions in this case, which when properly considered show that the essential control of the corporation and the essential relationship of the shareholders did not change. In its opinion the Tax Court at page 115 of the Record, states:

> "The facts show that after Petitioner surrendered 1,346 shares of Western stock, Peti-

> tioner's relationship to Western was essentially changed."

The Tax Court's consideration of the control of the corporation ended here. It clearly erred in considering only the redemptions of the corporation to October, 1949, without taking into consideration the subsequent purchase by petitioner of 252 shares from A. A. Schumann in January, 1950. Indeed, this purchase was made with the express intention of preserving Petitioner and A. A. Schumann as controlling shareholders of Western (T.R. 23).

Before the redemptions Petitioner held 40.4 per cent of the voting stock of Western or 2,094 shares out of 5,182 shares. A. A. Schumann held 24.1 per cent of the voting stock of Western or 1,252 shares out of the total of 5,042. Thus, Petitioner and Mr. Schumann controlled the corporation with a total of approximately 64 per cent of its stock, but neither controlled it without the other. In the course of the distributions made to shareholders in 1949 and 1950, Petitioner surrendered only a part of its shares and A. A. Schumann none (T.R. 22-23). At the conclusion of these transactions Western had outstanding 2,000 shares of stock of which Petitioner then owned 748 shares or 37.4 per cent, nearly the same percentage as before the transactions began. However, as A. A. Schumann had surrendered no shares his 1,252 shares, which before the transaction had represented 24 per cent of the outstanding stock, after the transaction represented 62.6 per cent. As the Stipulation of Fact

shows in Paragraph 6 on pages 22-23 of the Transcript of Record, Petitioner, for the purpose of maintaining the same general control of the company between A. A. Schumann and Petitioner, purchases 252 shares from Schumann, after which each held 50 per cent. Therefore, after the transactions, as before, both controlled the corporation, but neither controlled it as against the other. The situation regarding control and the essential relationship of the shareholders was fundamentally unchanged. The Tax Court was patently in error to ignore this situation as it did in its opinion (T.R. 115).

As is apparent from the nearness of time, this purchase was an integral part of the plan for a series of redemptions leaving Petitioner and Schumann still in control of the corporation (T.R. 23). Without the redemptions there certainly would not have been any purchase of A. A. Schumann's stock by Petitioner. Indeed, the only purpose of that purchase was to continue control in the corporation as it had been before the redemptions (T.R. 23).

The redemptions could not be considered separate and apart from the other integral stock transactions in judging the "net effect" of the distributions. *Boyle v. Commissioner of Internal Revenue* (C.A. 3rd Cir. 1951), 187 F. 2d 557, 560.

This factor of control, or relative stockholder position, not properly considered by the Tax Court, has led other courts to find that the redemption was "essentially equivalent to a taxable dividend." The Tax Court erred in not so finding.

IV. In This Case the Redemption of the Stock Served the Purpose of the Shareholders Only and Served No Legitimate Business Purpose.

The Courts are in accord in considering one of the primary factors to be used in determining whether the "net effect" of a corporate distribution is essentially equivalent to a taxable dividend, is whether there is a legitimate business purpose to justify the redemption of stock.

Flanagan v. Helvering (C.C.A. D.C. 1940), 116 F. 2d 937, 939;

Boyle v. Commissioner of Internal Revenue (supra) 561;

Commissioner of Internal Revenue v. Roberts (C.A. 4th Cir. 1953) 203 F. 2d 304, 306;

Smith v. United States (C.C.A. 3rd, 1941) 121 F. 2d 692, 695;

Samuel H. Kessner & Tessie D. Kessner v. Commissioner of Internal Revenue, 26 T.C. ...., No. 134 (Sept. 1956), C.C.H. 1956 Reg. Dec. No. 21,924.

Bazley v. Commissioner of Internal Revenue, (C.C.A. 3rd 1946), 155 F. 2d 237, 241, 244.

In the *Kessner* case (supra), the Court stated:

> "Thus, our principal concern is whether the 'net effect' of the transactions involved, absent a real and substantial business reason on the part of the corporation as distinguished from a purpose to benefit the shareholder, was to distribute accumulated earnings and profits among the shareholders the same as if a cash dividend had been declared and paid."

> "We readily distinguish our earlier decisions relied upon by petitioners. On those occasions we found that a real and substantial corporate purpose was actually accomplished by the stock redemptions."

The decision of this case to tax the redemptions as dividends within 115(g) was based primarily upon the finding of no substantial business purpose existing. In all the cases above cited the lack of a legitimate business purpose, such as permitting greater flexibility in financing, or removing restrictions on common stock dividends, was considered an important factor in determining the "net effect" of the distributions.

In the instant case no corporate purpose was served by the distribution of the accumulated profits, but rather the shareholders were served by having accumulated earnings, not needed in the business distributed to them. The corporation retained ample working capital with which to carry on its business (T.R. 42).

The Tax Court in its opinion even acknowledged the lack of any testimony pointing to a legitimate business purpose to justify the distribution (T.R. 117-118). However, the Court apparently considered this a factor weighing in favor of holding the distribution to be a sale or exchange. In this the Court was clearly in error. Properly considered this factor should be of primary importance in determining that the "net effect" of the transaction is that it is essentially equivalent to a taxable dividend. (Cases cited above).

D.

THE TAX COURT, IN DECIDING THAT THE DISTRIBUTION TO PETITIONER WAS A DISTRIBUTION IN PARTIAL LIQUIDATION, MADE A DETERMINATION NOT FOUNDED ON SUBSTANTIAL EVIDENCE.

As pointed out earlier in this brief, the Tax Court gave consideration only to one of the four major factors considered by the Courts to be controlling in this type of case. This one factor was the control of the corporation and the relationship of the shareholder to the corporation before and after the distribution. As shown by the discussion of this factor, beginning at page 18 of this brief, the Tax Court's consideration of this factor was mistaken and the conclusions drawn by the Court erroneous.

The Tax Court appears to have based its main reliance for its decision upon two relatively minor factors, contending that the fact that the corporation had, from time to time over its history, paid ordinary dividends and the fact that the distributions made to the shareholders in 1949 and 1950 were not in the technical sense "pro rata," justified its holding that the distribution to Petitioner was one in partial liquidation.

In the first place, as the cases cited in this brief show, these two elements are, of themselves, of minor importance compared to the major factors previously discussed. Standing alone, they would have no significance in determining whether a distribution was in the nature of a dividend or in the nature of a distribution upon partial liquidation.

So far as dividend payments are concerned, it is perfectly clear that the mere fact that such payments have been made prior to a distribution falling within the scope of Section 115(g)(1) does not automatically convert the latter distribution into a liquidating distribution. In *Rheinstrom v. Conner* (C.C.A. 6th 1942), 125 F. 2d 790, cert. denied, 317 U.S. 654, 63 S. Ct. 49, 87 L. Ed. 526 (1942), a distribution of $122,000.00 was made to shareholders upon cancellation of stock. This distribution was held to be equivalent to a taxable dividend although, in the same year, the corporation had paid $90,000.00 in ordinary dividends and had paid other similar dividends over a period of years from 1914 to 1936. These ordinary dividend payments were not considered as in themselves over-riding the effect of 115(g)(1).

A similar situation with similar results occurred in *Kessner v. Commissioner,* 26 T.C. ......, No. 134 (Sept. 1956); C.C.H. 1956 Reg. Dec. No. 21,924. There, a distribution of $100,000.00 in stock redemption was held to be essentially equivalent to a taxable dividend although the shareholders had already received $80,000.00 in ordinary cash dividends during the period under review. The Court considered that the payment of ordinary dividends supported rather than detracted from the conclusion that the redemption payments were taxable dividends.

In the instant case, the facts are very similar to both of the cases quoted above. From 1935 through 1949, a period of fifteen (15) years, Western had paid

ordinary dividends in eleven (11) of those years and paid an ordinary dividend in 1949 of $10.00 per share, amounting to $50,420.00 (T.R. 41). Yet likewise in 1949, Western made to Petitioner the distribution of $296,120.00, which is in issue here. Certainly this distribution is not automatically converted into capital gain by the mere fact that Western had followed a normal and usual corporate policy of paying ordinary dividends in other years. Were this true, Section 115(g)(1) would be meaningless, as it could never apply to a purchase of stock by any corporation which had paid ordinary dividends prior to a distribution made upon stock redemption. To make a finding that such a distribution is one in partial liquidation because of the existence of previous ordinary dividend payments is to make a finding unsupported by substantial evidence. This one factor, a minor one, cannot be considered "substantial".

A finding that a distribution otherwise within the purview of 115 (g)(1) is a liquidating distribution merely because it is not "pro rata," is likewise unsupported by substantial evidence. Unless other factors are present, whether a distribution is or is not pro rata is not decisive of the nature of the distribution. It is obvious that distributions unquestionably in complete liquidation of a corporation are normally pro rata; yet this does not bring them within Section 115(g)(1). It is equally obvious from an examination of the cases cited in this brief that the fact that distributions are not pro rata does not necessarily exclude them from the operation of 115(g)

(1). Where mentioned in the cases at all, the element of proration is treated as a minor factor, of little consequence by comparison with the major factors which we previously described, and in two (2) cases, the distribution has been treated as essentially equivalent to a taxable dividend despite the fact that it was not in any sense pro rata. In *Boyle v. Commissioner* (C.A. 3rd Cir. 1951), 187 F. 2d 557, Boyle surrendered to the corporation 3,302 shares of 3,602 owned by him; another shareholder surrendered to the corporation 3,202 shares of 3,502 owned by him; yet Boyle's distribution was considered a taxable dividend. Again, in *McGuire v. Commissioner* (C.C.A. 7th 1936), 84 F. 2d 431, two (2) shareholders received distributions upon cancellation and redemption of the stock and a third shareholder, holding one share, received nothing. This fact did not, in the Court's view, change the character of the distribution from that of a dividend.

The Court said in 84 F. 2d, at page 433: "We think this fact unimportant and in no effect controlling."

If all that were necessary to render 115(g)(1) inapplicable were the absence of pro rata distribution, the effect of 115(g)(1) could easily be avoided by taxpayer-shareholders taking accumulated earnings out of corporations merely by making the distribution not pro rata. Surely such a result was not intended, particularly when other factors are present which have been found by the cases to be controlling. Furthermore, were this true, there would have been no need for Section 115(g)(3), which reads in part as follows:

> "Redemption of Stock to Pay Death Taxes.— The provisions of this subsection shall not apply to such part of any amount so distributed with respect to stock the value of which is included in determining the value of the gross estate of a decedent in accordance with section 811 . . ."

The whole purpose of Section 115(g)(3) is to enable the estate of a deceased shareholder to sell to the corporation in which he owned stock part or all of his stock without encountering the consequences of Section 115(g)(1). Since such a sale would obviously not be made on a pro rata basis, the section is pointless unless it were the plain intention of Congress that 115(g)(1) was not to be denied effect by the mere fact that the transaction involves only one shareholder or less than all shareholders or, in other words, is not pro rata.

It is submitted, therefore, that neither payment of dividends in the past nor the fact that a distribution is not made pro rata among all shareholders nor both in combination can constitute, standing alone, sufficient evidence that the distribution is one in partial liquidation as the obvious effect of such a holding would be to deprive Section 115(g)(1) of all practical effect.

E.

THE LEADING CASES IN THIS FIELD OF TAX LAW SUPPORT PETITIONER'S POSITION.

The cases discussed below, and the cases cited therein, are the leading cases in this field. They support Petitioner's position.

In *Flanagan v. Helvering* (C.C.A. D.C. 1940), 116 F. 2d 937, the Reviewing Court affirmed the Tax Court's decision that monies received by the taxpayer were "essentially equivalent to a taxable dividend." The facts of this case were as follows: the co-executor of an estate holding stock in a corporation also represented all the shareholders of the corporation. By reason of his control position, the co-executor was able to cause 184 shares of the common stock held by the estate to be redeemed and cancelled by the corporation and likewise caused 184 shares held by another shareholder to be redeemed and cancelled. The redemption was treated as within Section 115(g) by the Commissioner, the Tax Court and the Court of Appeals. The co-executor treated the redemption as a partial liquidation within Section 115(c). The Court at page 939 took cognizance of the principal tests that had been determined in placing the transaction within 115(g). The Court noted that "the major part of the capitalization represented former earnings; only two relatively small cash dividends were paid; the principal ownership of the shareholders was not changed; the corporation did not manifest any policy of contraction; the initiative for the corporate distribution

came from a stockholder who needed cash; it has continued to operate at a profit."

It should be noted that in this case there was a transfer of shares made, prior to the redemption, with the express intent that the shareholders should each hold an equal number of shares.

The usual tests of determining "net effect" were met to support the Court's opinion. It is interesting to note that in the *Flanagan* case the Court decided against the taxpayer in finding that the distribution was "essentially equivalent to a taxable dividend," whereas in the instant case, even though the facts are very similar, the Tax Court, deciding again against the taxpayer, found that the distribution was in partial liquidation.

In *Fostoria Glass Co. v. Yoke* (D.C.W.V. 1942), 45 F. Supp. 962, the Court found the acquisition at call price by a corporation of its preferred stock to be "essentially equivalent to a taxable dividend" within Section 115(g). The reacquisition was financed out of current earnings of the company. The Court's opinion contains the following language in 45 F. Supp. at page 965:

> "Following the 'beacon' established by these cases, as well as the 'guiding stars' pointing thereto, the Court can reach but one conclusion in this case. The issuance and reacquisition of its A and B Preferred stock by Diamond did not result in a diminution of the capital structure. It did not result in a restriction of the company's business. It was not a partial liquidation. There were in existence no sound business reasons for

the transaction. The cash dividends paid were not commensurate with the net earnings of the company. The capital stock of the company was closely held. The company was at all times possessed of much more cash and negotiable securities than was adequate to meet its operating needs. The Court must, therefore, find that the issuance of this stock by Diamond of Delaware and its reacquisition by that company was substantially equivalent to the distribution of a taxable dividend under the provisions of Section 115(g). Being such taxable dividends, the plaintiff, under the provisions of Section 23(p) of the Revenue Act of 1934, 26 U.S.C.A. Int. Rev. Acts, page 674, is entitled to a dividend received credit for the sums received by it upon the redemption of eleven hundred twenty-five shares (1,125) shares of Series A Preferred stock during its fiscal year ending June 30, 1935, and to dividend received credit of eighty-five per cent (85%) on the amounts received upon the redemption of one thousand (1,000) shares of Series B Preferred stock during its fiscal year ending June 30, 1937."

It is to be noted that in the *Fostoria* case, as in the case before us, the application of the principles enunciated resulted in a substantial reduction in the tax payable due to the application of the dividends—received credit, to which the taxpayer as a corporation was entitled in view of the distributions having been the equivalent of a dividend.

In *Commissioner v. Forhan Realty Corporation* (C.C.A. 2d 1935), 75 F. 2d 268, the taxpayer, a corporation, surrendered its stock in another corporation,

the Forhan Company, receiving cash and other securities therefor. The Forhan Company had ample earnings and profits, undistributed, to cover all of its distribution. Under the statute relating to the transaction, Section 112(c)(2), Revenue Act of 1928, such a distribution could be treated as a taxable dividend if the distribution "has the effect of the distribution of a taxable dividend." The taxpayer, however, being a corporation, was not then taxable on dividends received. The Court of Appeal for the Second Court held, nevertheless, that the distribution should be treated as a dividend, even though the result was that no tax was paid. The Court said in 75 Fed. 2d at page 269:

> "Where the section refers to a distribution which 'has the effect of the distribution of a taxable dividend,' 'taxable dividend' is to be considered from the viewpoint of the corporation making the distribution, and, where the distribution has the effect of what is ordinarily considered a taxable dividend, from the distributing corporation's viewpoint, section 112(c) (2) is applicable to the entire distribution, without regard to whether there is a possibility of parts of the distribution going to some distributees which parts, if viewed as ordinary dividends, would be nontaxable to such distributees either because the distributees are corporations or because they have not sufficient income to be subject to surtax."

In *Boyle v. Commissioner of Internal Revenue* (C.A. 3d Cir. 1951), 187 F. 2d 557, the Court of Appeals held that the circumstances surrounding the pay-

ment by the company to the taxpayer supported the view of the matter taken by the Tax Court that the "net effect" of the distribution to the Petitioner amounted to a taxable dividend. The distributing corporation, in this case, redeemed a large part, but not all of the shares owned by the taxpayer. The Court stated in 187 F. 2d at page 560:

> "All of the other circumstances surrounding the payment by the company to petitioner strongly support the view of the matter taken by the Tax Court that the net effect of the distribution to petitioner amounted to a taxable dividend. The company had never paid any cash dividends. There was no manifestation by it of any policy of contraction or liquidation. The initiative for the distribution came from the majority stockholders. There was, as found by the Tax Court, 'a large earned surplus and an unnecessary accumulation of cash, both of which were reduced as they would have been by the declaration of a true dividend.' "

This case is of primary importance in its recognition of stock transactions, other than the specific redemptions of stock, which were undertaken to continue the control of the corporation the same after the distribution as before. In commenting on this situation the Court said in the same report at page 560:

> "Eventually, as already noted, petitioner actually possessed one-third of the company's outstanding stock as he had originally. Certainly there is sufficient evidence to warrant the holding of the Tax Court that the distribution to petitioner, Tiffany, and the Glover Estate was according to a pre-

> arranged plan. Commenting on that situation Judge Opper, in his excellent opinion below, said 'Although it took something over a year to accomplish, the upshot was, as our findings show, that a corporation, with three principal stockholders holding their shares in virtually equal proportions, distributed to them the bulk of its accumulated earnings and that ultimately there remained three shareholders again with identical holdings.' "

It should be noted that in this case there was no pro rata redemption and yet the Court held the distribution to be a taxable dividend.

In *Commissioner of Internal Revenue v. Roberts* (C.A. 4th Cir. 1953), 203 F. 2d 304, the Court of Appeals reversed the Tax Court's decision holding that redemption of an entire block of corporate stock formerly owned by taxpayer's brother and bequeathed by him to taxpayer had not consisted of a distribution essentially equivalent to a dividend. The Court of Appeals held that the Tax Court's decision had been erroneous since, inter alia, the taxpayer's essential relationship to the corporation, in which he was sole stockholder, had not been changed in any practical aspect by redemption.

The Appellate Court stated there was little or no dispute about the facts of the case. The earnings and profits of the corporation prior to the redemption were accumulated for no definite purpose; the operations of the corporation were not impaired by reason of the transaction in controversy; the corporation

had never followed a policy of contraction of business, and the corporation continued in the same business in subsequent years. The Court of Appeals noted that the Tax Court found that the payment of $92,000.00 to the taxpayer was a distribution in complete cancellation and redemption of all of that portion of the corporation's stock bequeathed by taxpayer's brother, and then had erroneously held that this redemption constituted a partial liquidation and was not the essential equivalent of the distribution of a taxable dividend. The Court reasoned that, "The vital thing here, as we see it, is that by the redemption of this stock, the essential relation of the taxpayer to the corporation was not, in any practical aspect, changed." The Court stated in 203 F. 2d at page 306:

> "Here, then, we find a single individual owning all the corporate stock. *Flanagan v. Helvering,* 73 App.D.C. 46, 116 F.2d 937; *Bazley v. Commissioner,* 3 Cir., 155 F.2d 237, 239, affirmed 331 U.S. 737, 67 S.Ct. 1489, 91 L.Ed. 1782. The corporation had on hand a large and unnecessary accumulation of cash, representing 'earnings or profits accumulated after February 28, 1913.' *Hirsch v. Commissioner,* 9 Cir., 124 F.2d 24, 29. The corporation did not then intend to liquidate or to contract its business. *Rheinstrom v. Conner,* 6 Cir. 125 F.2d 790, 793, certiorari denied, 317 U.S. 654, 63 S.Ct. 49, 87, L.Ed. 526. The redemption served no business purpose of the corporation; it was motivated entirely by the personal considerations of taxpayer. *Commissioner v. Snite,* 7 Cir. 177 F.2d 819; *Smith v. United States,* 3 Cir., 121 F.2d 692, 695. The net effect of the redemption

> was clearly to distribute to taxpayer the corporate earnings just as if a cash dividend had been declared. *Kirschenbaum v. Commissioner,* 2 Cir., 155 F.2d 23, 170 A.L.R. 1389, certiorari denied 329 U.S. 726, 67 S.Ct. 75, 91 L.Ed. 628; *Hyman v. Helvering,* 63 App. D.C. 221, 71 F.2d 342, certiorari denied 293 U.S. 570, 55 S.Ct. 100, 79 L.Ed. 669. See, also, Noland, 'The Uncertain Tax Treatment of Stock Redemptions: A Legislative Proposal, 65 Harv. L. Rev. 255; Pedrick, "Some Latter Day Developments in the Taxation of Liquidating Distributions." 50 Mich.L.R. 529. Indeed, it is difficult to imagine a more ideal set-up for the application of Section 115(g) than the facts involved in the instant case.' "

Indeed, it is difficult to imagine a case more in point than *Commissioner v. Roberts.* Here the Trial Court was reversed, the distribution was held to be a dividend, the facts were not in dispute, and the facts were similar to those in the instant case.

In *Kessner v. Commissioner* (2 cases), Docket Nos. 53108, 53109. 26 T.C. ...., No. 134 (Sept. 1956), C.C.H. 1956 Reg. Dec. No. 21,924, the Tax Court held that a distribution in redemption of stock was made in such time and in such manner as to be essentially equivalent to the distribution of a taxable dividend under Section 115(g) of the 1939 I.R.C. Petitioners' preferred stock was redeemed pro rata by their closely held corporation under circumstances in which (1) there was no diminution of their proportionate interest in the cor-

poration; (2) there was no contraction of the corporation's capitalization or its activities, rather both increased; (3) cash on hand and earnings and profits in substantial amounts were available; (4) no real or substantial corporate business purpose was proved.

The redemption in this case consisted of $100,000.00 paid for preferred stock which was retired according to its terms. The Court arrived at its decision by applying the primary tests which have been established by judicial precedent. The Court reasoned in its opinion that:

> "Congress has broadly advanced the term dividend to include *any distribution* made by a corporation to its shareholders out of earnings and profits. 1939 Code, section 115(a). (Emphasis added). Moreover, as far back as 1926 Congress plugged the loophole whereby in the disguise of a non-taxable cancellation, redemption or partial liquidation of stock 'a corporation, especially one which has only a few stockholders, might without resorting to the device of a stock dividend, be able to make a distribution to its stockholders which would have the same effect as a taxable dividend.' "
>
> "Thus, our principal concern is whether the net effect of the transactions involved, absent a real and substantial business reason on the part of the corporation as distinguished from a purpose to benefit the shareholders, was to distribute accumulated earnings and profits among the shareholders the same as if a cash dividend had been declared and paid. *James F. Boyle,* 14 T.C.

1382 [Dec. 17,721], affd. 187 Fed. (2d) 557 (C.A. 3, 1951) [51-USTC Par. 9196]; certiorari denied, 342 U. S. 817; *Smith v. United States,* 121 Fed. (2d) 692 (C.A. 3, 1941) [41-2 USTC Par. 9565]; *Brown v. Commissioner,* 79 Fed. (2d) 73 (C.A. 3, 1935) [35-2 USTC Par. 9526]; *Flanagan v. Helvering,* 116 Fed. (2d) 937 (C.A. D.C., 1940) [40-2 USTC Par. 9710]."

"The decision in each case will depend upon its own particular circumstances. Treasury Regulations 111, section 29.115-9."

"Secondly, by all of the tests the present transactions are governed by section 115(g). *Flanagan v. Helvering,* supra; *Brown v. Commissioner,* supra; *James F. Boyle,* supra; *Smith v. United States,* supra; *Hyman v. Helvering,* supra; *Estate of Charles D. Chandler,* supra. There was no retrenchment of corporate activities. There was no contraction of corporate invested capital. In fact, both increased. There was no alteration or diminution in petitioners' proportionate interest in the corporation."

"The only practical effect of the redemptions was to make cash distributions of corporate earnings and profits pro rata among the shareholders the same as if a dividend in cash had been declared and paid."

It is of particular importance to note that in this case the Court specifically stressed that the fact that the shareholders had already received nearly $80,000.00 of cash dividends during the period under review *supported* rather than detracted from the

Court's conclusion that the redemptions were taxable dividends. The Court said:

> "The fact that the director-officer-shareholders had already received nearly $80,000.00 of cash dividends during the period under review supports rather than detracts from our conclusion."

This use of prior dividends to support the Tax Court's decision that the distributions made in redemption of the stock were essentially equivalent to a taxable dividend points up in a striking manner the weakness of the Tax Court, in the case at bar, relying upon existence of prior dividends to support its decision that the redemptions were made in partial liquidation. The fact that there were prior dividends, it must be remembered, was one of the two factors that the Tax Court cited as supporting its determination. We have already noted that this test is, at best, a secondary test not usually given much weight, and here we have the Tax Court itself citing the existence of prior dividends as support for the view of Petitioner.

CONCLUSION.

It is respectfully submitted that since:

(1) The Tax Court erred as a matter of law in holding that the distribution to Petitioner was not a distribution essentially equivalent to a taxable dividend; and

(2) The decision of the Tax Court that the distribution made in redemption of Petitioner's stock was a distribution in partial liquidation is not based upon substantial evidence;

The decision of the Tax Court in this case should be reversed.

Dated, San Francisco, California.
February 20, 1957.

Dudley F. Miller,
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